

February 23, 2024

Mr. Shigeru Ariizumi
Chair, Executive Committee
Mr. Jonathan Dixon
Secretary General
International Association of Insurance Supervisors (IAIS)
Bank for International Settlements
CH-4002 Basel
Switzerland



Re: IAIS Draft Application Paper on climate risk scenario analysis in the insurance sector

Dear Messrs. Ariizumi and Mr. Dixon:

The Institute of International Finance (IIF) and its insurance members¹ are pleased to respond to the IAIS's Draft Application Paper on climate risk scenario analysis in the insurance sector (Draft Application Paper). The IIF has been leading and supporting efforts within the broader financial services industry to advance sound risk management practices for climate-related financial risks, including the use of climate scenario analysis. Last year, the IIF analyzed insurer approaches to climate scenario analysis, which culminated in the publication of its report, "Supervisory and Industry Approaches to Insurer Climate Scenario Analysis and Stress Testing."² Many of the insights from this IIF report, which was informed by the practical experiences of IIF members, have helped inform our response to this Draft Application Paper.

We understand the interest of the IAIS in developing guidance for jurisdictions on how climate risk scenario analysis should be considered in light of Insurance Core Principles (ICPs) 16 and 24. However, we believe that the IAIS should go back to first principles in drafting an Application Paper. As noted in the preface to the Draft Application Paper, Application Papers provide supporting material related to specific supervisory material in the ICPs or ComFrame by providing further advice, information, recommendations, or examples of good practice. Application Papers are subject to the principle of proportionality and should not include new requirements that go beyond the scope of the existing ICPs. This distinction is important as, in practice, Application Papers are often interpreted by supervisors as prescriptive requirements from the IAIS and, by extension, failure to implement them could give rise to negative assessments. We encourage the IAIS to reiterate and clarify the purposes and intent of an Application Paper for the benefit of its members and stakeholders and to reflect the intended purpose of an Application Paper in redrafted language in any final Application Paper.

¹ References to insurers in this letter also apply to reinsurers unless specifically noted.

² https://www.iif.com/portals/0/Files/content/32370132_iif_insurance_climate_scenario_analysis_report_-_final.pdf

Overarching Comments

The Draft Application Paper reflects an overly optimistic view of the current state of climate risk modeling and climate scenario analysis. While the Introduction to the Draft Application Paper notes that climate-related scenario analysis is still in its early stages as a risk assessment tool and discusses some of the current limitations of these analyses, the remainder of the Paper reflects an overly optimistic view of the current state of the art and potential use cases for climate scenario analysis without appropriately reflecting and discussing the limitations of climate scenario analysis. The Paper reflects an overconfidence in climate scenario analysis use cases that does not appropriately consider important limitations and modeling challenges. We believe that the Draft Application Paper would benefit from setting out these limitations in more detail, and we encourage the IAIS to continue to consult with industry, climate scientists, and modeling experts before progressing this work to a final Application Paper. Importantly, the IAIS and its member supervisors should avoid being overly prescriptive and should pursue a principles-based and incremental approach to climate risk scenario analysis, where methodologies and approaches are still developing.

The Draft Application Paper addresses a broad range of issues relevant to climate scenario analysis, including macroprudential considerations and the use of scenario analysis to inform insurers' risk management and governance. Given the far-reaching scope set out in the Draft Application Paper for this topic and in consideration of the limitations of climate scenario analysis as set out in this response, we strongly encourage the IAIS to take an incremental approach to climate scenario analysis. For instance, the IAIS should first explore climate scenario analysis objectives and exercise design considerations in a microprudential context before progressing to address the complex topic of how climate change can be a driver of systemic risk. The work of the IAIS on climate-related risks and scenario analysis can be an input into its broader macroprudential analyses, but forward-looking climate scenario analysis needs more exploration and development before becoming part of a broader macroprudential analysis.

We are also concerned that some of the use cases provided in the Draft Application Paper for climate scenario analysis for firm-specific exercises and, in particular, as a tool to inform enterprise risk management are overly optimistic. We encourage the IAIS to review with experts in climate scenario analysis the potential use cases put forward in the Draft Application Paper in order to confirm the potential situations in which climate scenario analysis can be decision-useful for risk management. More aspirational use cases should be clearly identified as such in any final Application Paper.

Climate scenario analysis should not be conflated with business-as-usual climate risk management. Climate scenario analysis, which employs longer-term, forward-looking climate modelling, differs from business-as-usual climate risk management over the near- to mid-term, and the two should not be conflated. Climate change should be seen as an additional risk driver on top of existing climate risk management. Forward-looking impacts are dependent on a number of assumptions and estimates that make their use in influencing business strategies and decisions over the business-as-usual time horizon considerably less reliable.

The discussion of transparency in Section 4.3 of the Draft Application Paper should be substantially revised given that the output from climate scenario analysis exercises are - at least over the near-term - likely to be imprecise and unreliable in light of the complexity and methodological and data challenges associated with the exercises. Disclosing such information runs the risk of misleading stakeholders and would pose undue risks to insurers.

Paragraph 47 states that publishing the results of climate scenario analysis exercises can send a clear message about the potential climate-related risks posed to the insurance sector. However, given the data and methodological limitations discussed above, this statement is not fully accurate. Moreover, we believe that this statement overlooks the potential for the disclosure of the results of exercises to create confusion among investors and other stakeholders that receive and use these disclosures in their decision-making, which gives rise to significant litigation and reputational risks for the industry. Further consideration of the risks of public disclosure is provided in the IIF's comment letter on the IAIS market conduct consultation. Substantial improvements in data and modeling are needed before the results of climate scenario analysis will be decision-useful to the users of insurers' disclosures.

Climate scenario analyses over a range of timeframes can be useful to an insurer for strategic planning and for testing the viability of various business models over a longer time horizon, but they are not a suitable tool to inform concrete decision making, particularly for short tail lines of business such as property catastrophe. This lack of suitability for decision making arises from the need to align the assessment horizon with the duration of the underlying liabilities in order to inform concrete business decisions. In particular, exercises that are designed to explore longer timeframes may result in outputs that exceed those arising from risk-based capital calculations. In addition, the considerable potential for error in scenario analysis results can make firms reluctant to draw any firm conclusions that would inform business plans or strategy.

An obligation to disclose the results of those analyses should respect the uncertainty and potential business sensitivities of the outcomes, otherwise it would have a chilling effect on the willingness of insurers to engage in these exercises. Individual firm's results should not be disclosed publicly, as they conflict with legally required disclosures and would result in confusion and misunderstanding to the serious detriment of the users of disclosures, disclosing firms and the sector as a whole. The significant litigation risks to insurers arising from misunderstanding these disclosures and from the fact that the results may not be sufficiently reliable should not be overlooked by insurance supervisors.

Supervisors should strictly limit the publication of any results of their supervisory exercises to anonymized and aggregated information and should strongly caveat any findings in order to reflect the limitations of those exercises. Supervisors should strictly avoid any publication of individual firm's scenario analysis results given the substantial uncertainty and business sensitivities surrounding those results.

We propose a redrafting of Section 4.3 in our specific comments below.

The use of climate scenario analysis as a prudential supervisory tool is not appropriate in light of the uncertainty around climate change outcomes and shortcomings in data availability and reliability. While the use of climate scenario analysis as a prudential supervisory tool is not appropriate, it can serve a valuable role in facilitating supervisory discussions with insurers or in testing the long-term viability of an insurer’s business model. The IAIS should not promote the use of climate scenario analysis to inform firms’ capital and solvency requirements.

Climate-related risk drivers of financial risk should not be elevated over other insurance risk drivers.³ While climate-related risk drivers of financial risk are undoubtedly an important consideration for insurers and supervisors, they should not be elevated above other risk drivers to an insurance enterprise unless a materiality determination provides evidence that it is in fact more significant to the organization than other risks and, thus, should be prioritized. For some insurers, climate-related risk drivers may be significant, whereas for others, non-climate-related risk drivers may pose the larger threat to their business model over a longer time horizon. Elevating climate-related risk drivers over other more material risk drivers can distort supervisory and firms’ business decisions and, hence, is in conflict with the very objectives of prudential supervision.

We welcome the delineation of specific climate-related risks by insurance lines of business in Table 3 of the Draft Application Paper. This approach should be carried through the remainder of the Paper, including in the discussion of scenario analysis design considerations, including in Tables 4 and 5.

There continues to be a need for supervisors to increase their alignment of supervisory approaches to climate-related risks, including climate scenario analysis. While the Draft Application Paper calls for greater alignment of supervisory approaches to climate scenario analysis, the various case studies contained in the Paper reveal considerable divergence among jurisdictions in their approaches to supervisory exercises and guidance on this topic. As noted in a recent IIF report,⁴ regulatory fragmentation has many negative consequences for both the financial services industry and its customers and counterparties. The IAIS should continue to encourage its member supervisors to work collaboratively to increase alignment on supervisory approaches to climate-related risks, including climate scenario analysis.

Supervisory climate scenario analysis exercises should be limited in scope and tied directly to supervisory mandates and objectives. Supervisory requests for industry participation in climate scenario analysis exercises should be tied directly and specifically to the supervisory mandate and objectives. The exercises should be proportionate, flexible, and focused on the material climate-related risks faced by exercise participants. Supervisors should recognize that insurers with global operations often are contending with multiple, varying exercises with overlapping and ambitious timeframes and, accordingly, tailor their exercises to focus on the most material exposures that are directly relevant to their supervisory objectives.

³ The first clause of Paragraph 1 of the Draft Application Paper should be amended to read, “Climate change is a **driver** of financial risk...”

⁴ https://www.iif.com/portals/0/Files/content/32370132_iif_scer_market_fragmentation_vf_03_02_2023.pdf

Paragraph 46c. advocates for supervisors to conduct follow-up scenario analysis exercises to identify emerging risks or trends. While, in principle, this suggestion is valid, it does not reflect the considerable uncertainty surrounding the results of these exercises and the serious risk of compounding erroneous results, which can lead to self-fulfilling prophecies arising from the inherent presumption that a particular trend will develop (i.e. attempting to prove a trend by calculating the potential impact should a presumed trend materialize), circular reasoning and a false sense of precision in the outcomes. Supervisors should fully understand and digest the results of their initial exercises and verify the assumptions and estimates on which they are based before engaging in follow-up analyses. Moreover, supervisors should interpret the outcomes of supervisory exercises through the lens of materiality.

Supervisors’ climate scenario analysis exercises should not ‘crowd out’ insurers’ internal analyses. Insurers and supervisors have a common goal to enhance climate-related risk management practices, including the use of climate scenario analysis. Given the considerable expertise in modeling and scenario analysis in the industry, it may be appropriate for insurers to take the lead in advancing sound climate scenario analysis practices. Insurers are best placed to tailor the analysis to their risk profile and business model. In contrast, top-down supervisory approaches limit the ability to tailor the analysis and, therefore, produce results that are less valuable to an insurer. At a minimum, supervisory capacity building would be enhanced and accelerated through collaboration with private sector experts in risk management and modeling.

Specific Comments

Section 2 – Scenario analysis versus stress testing

Paragraph 13 states that climate-related scenario analysis exercises can be used to identify and assess emerging risks that may arise over time so that insurers can take appropriate action to effectively and proactively manage those risks. We agree with the statement that climate exercises can be used to identify and assess emerging risks, but the use of the results of forward-looking climate scenario analysis exercises in business decision making and capital allocation is limited due to data gaps, issues related to data quality and reliability, methodological constraints, and the need to rely significantly on assumptions and estimates. These data and methodological limitations constrain the ability of insurers to use climate scenario analysis as an effective tool in decision making at the present time. We anticipate that further advances in data quality and modeling will make the results of climate scenario analysis more decision useful over time. However, some structural limitations will remain, e.g., the decision usefulness of such forward-looking assessments for short-term liabilities or capital requirements.

Paragraph 14 states that climate-related scenario analysis could be used to measure the compounding impact of several catastrophe risk perils occurring consecutively in short order. We believe that the state of the art of climate scenario analysis is not yet sufficiently advanced to make the results from any such analysis reliable. Paragraph 14 also states that non-life insurers could use scenario analysis to measure the compounding impact of several catastrophe risk perils occurring consecutively in short order. While climate scientists and modeling experts are exploring multi-peril

impacts, we understand that the results of those exercises generally are not considered fully reliable for use in business decision making at the present time.

Section 3 – Scenario analysis objectives and scenario design

We encourage the IAIS to more clearly delineate the supervisory objectives of climate-related scenario analysis before outlining extensive design considerations in this Section. The extensive list of objectives set forth in Table 4 should be more carefully limited in order to produce exercises that are more likely to result in information and analyses that are decision-useful for insurers and their supervisors.

In addition, the scientific knowledge around climate change does not change that frequently, which limits the usefulness of annual exercises. Supervisors should consider less frequent formal supervisory exercises and place greater reliance on discussions with insurers based on their firm-specific assessments.

In designing climate scenario analyses, it is important to reflect that climate change is a risk driver that is already embedded in an insurer's financial risks, to the extent that it is deemed material to the firm. For example, the impact of climate change on real estate holdings in a particular location may be well reflected in the current credit risk assessment. Double counting should be avoided as it could lead to flawed analysis and inputs to decision-making. In other cases, it may be difficult to isolate certain risks. For example, isolating climate transition risks, which are one of several drivers of spread risk, can be extremely challenging due to data limitations and model bias that can arise when attempting to isolate transition risk from other drivers using traditional methods such as bivariate and multivariate regressions.

We do not believe that scenarios should reflect climate tipping elements or tipping points and we would delete the reference to tipping points in Paragraphs 29 and 58b. of the Draft Application Paper. Tipping points are subject to competing theories and are not precisely known. The term is also generally interpreted as meaning that a particular system will 'tip' very abruptly once the threshold is crossed, which may not be necessarily true for a particular tipping element. Multiple thresholds may govern a particular tipping element, and climate change may influence a range of different feedback effects. That said, state-of-the-art climate models (e.g. CMIP6⁵), represent all physical processes of the climate system, including feedback processes and potential tipping points. As such, they are already reflected to the extent possible and should not be singled out. We would therefore recommend that the IAIS not ask supervisors to include tipping points in their analyses, nor should supervisors require firms to include tipping points in their firm-specific analyses beyond widely recognized scientific climate models.

⁵ Coupled Model Intercomparison Project Phase 6 (CMIP6), which forms the basis for the IPCC Reports, represents all physical processes of the climate system, including feedback processes and potential tipping points.

Section 4 – Macroprudential considerations for supervisors

We understand and share the IAIS’s interest in emerging developments that may affect the insurance sector’s risk exposures. The Holistic Framework for the Assessment and Mitigation of Systemic Risk in the Insurance Sector (Holistic Framework) is designed to increase the resilience of the sector through a global monitoring exercise that assesses trends and development in the sector in order to detect the possible build-up of systemic risks. The IAIS’s review of system-wide climate-related risks should be directly linked to the Holistic Framework and conducted through the global monitoring exercise, as was done in 2021. Notably, the 2021 Global Insurance Market Report (GIMAR) Special Topic Edition on climate-related risks (2021 GIMAR)⁶ results indicated that, considering the solid overall solvency position of the global insurance sector, the sector as a whole appears to be able to absorb investment losses from all scenarios tested and that transition risks from climate change generally are manageable for the insurance sector.⁷ The findings from the 2021 GIMAR are not appropriately reflected in the Draft Application Paper and should be discussed in any final Application Paper.

The IAIS can play an important role in coordinating supervisory exercises through the GIMAR, thereby limiting the growing proliferation of supervisory exercises with different objectives and design features. The IAIS can also serve as a forum for discussing the results of supervisory exercises and for determining when material changes in the industry’s risk profile or material advancements in modeling and scenario analysis warrant a further review or analysis of past findings. The IAIS and its members should not presume that annual or bi-annual exercises are necessary; rather, they should base a decision to conduct follow-on work based on a material change in scientific literature or on significant advancements in methodology and techniques that can provide new insights to both supervisors and the industry.

Paragraph 25 of the Draft Application Paper should reflect an approach to supervisory exercises that ties specifically to the Holistic Framework, rather than the focus on domestically systemically important insurers or locally headquartered internationally active insurance groups. We encourage the IAIS to take a sector-wide view of climate-related risks, consistent with the approach taken in the 2021 GIMAR.

Paragraph 35 of the Draft Application Paper attempts to put into context the macroprudential considerations for supervisors but fails to recognize the important role that insurers play in reducing the economy-wide risks and impacts of climate change through mitigation, adaptation, and risk transfer measures. In developing a proportionate approach to the macroprudential treatment of climate risk considerations, the IAIS should recognize the positive contributions to financial system-wide resilience that are made by the insurance sector, including by developing innovative new products, by adopting internal policies and practices to reduce their carbon footprints, and by considering climate-related considerations in their investment policies and in their engagement with investees.

⁶ <https://www.iaisweb.org/uploads/2022/01/210930-GIMAR-special-topic-edition-climate-change.pdf>

⁷ <https://www.iaisweb.org/uploads/2022/01/210930-30-September-2021-IAIS-Press-Release-GIMAR-2021-special-topic-edition.pdf>

With respect to the discussion of climate-related risk concentrations in Section 4.3.1, there are serious methodological and modeling challenges related to assessing and measuring climate-related risk concentrations that make any system-wide analysis of concentration risk subject to considerable uncertainty and imprecision. The determination of the impact of perils and the quantification of the effects of physical and transition risk correlations (see also Box 5) are subject to substantial uncertainty, as a result of the need to rely on information that is incomplete or subject to a high degree of estimation, assumptions that may or may not prove valid, and dependencies that may not be readily apparent or well understood. It is important to first assess the materiality of portfolio risks before considering more complex issues around concentration risks.

These shortcomings can seriously compromise the decisions that supervisors might make based on this information. It is very difficult even for individual insurers or insurance groups to conduct these analyses; the state of the art is not sufficiently advanced at the present time for supervisors to attempt to use these analyses for macroprudential purposes. To do so could give rise to the potential for unintended consequences and supervisory decisions based on inaccurate or incomplete information. These risks are compounded when consideration is given to assessing spillover effects to the real economy and other sectors (see Paragraph 43).

Moreover, the lack of common and well-developed definitions of some key terms impedes the ability of insurers or supervisors to conduct a meaningful assessment of concentration risks. We appreciate the IAIS providing definitions of certain key terms in Table 2 but other key terms still need clear and aligned definitions. For example, Paragraph 44 discusses carbon-intensive and green assets without clarifying the IAIS's definition of these terms. Moreover, there are a multiplicity of definitions across jurisdictions and among insurers and supervisors, which complicate any analysis of transition risk concentrations. Moreover, Paragraph 44 focuses on carbon-intensive assets as a potential source of micro and macroprudential risk, which overlooks other potential drivers of financial risk.⁸ It should also be acknowledged that carbon-intensive assets will continue to play an important role as economies transition to net zero.

With respect to the use of climate scenario analysis to explore the impact of climate change on capacity (See Box 2), we do see a useful role for climate risk maps, such as those constructed by EIOPA, that can help provide national, regional, and local governments to better assess potential impacts of natural catastrophe events and to develop mitigation and resilience strategies and community education programs. However, a broader role for climate scenario analysis in understanding the impact of climate change on protection gaps (see objective 9 of Table 4), goes beyond the current capabilities of insurers' climate modeling and is subject to significant assumptions, dependencies, and uncertainties. As a result, it is unlikely that any exercise designed to understand the impacts of climate change on protection gaps would result in the development of actionable information.

⁸ [IJF-WTW 2023 research](#) explores conceptually and empirically why GHG emissions or GHG emissions intensity are not a comprehensive indicator of a corporate's exposure to transition risk and, therefore, to financial risk to a financial institution doing business with the corporate.

As noted in our overarching comments, the discussion of transparency in Section 4.3 of the Draft Application Paper should be substantially revised in light of the substantial risks of disclosing the results of climate scenario analysis given data and methodological constraints.

We propose the following language to replace current Section 4.3:

Context

47. When considering transparency of scenario analysis exercises, supervisors should consider carefully the risks and benefits of publishing results in light of the data limitations, methodological constraints, and uncertainty associated with forward-looking climate risk modeling and climate scenario analysis.

Recommendations

48. Recognizing these limitations, constraints and uncertainty, supervisors should limit any publication of results to high-level, aggregated results and allow firms to determine if and to what extent additional information regarding the results of exercises should be disclosed to the public.

49. The publication of information from analyses conducted over mid- to longer time horizons should respect and clearly state the significant uncertainty surrounding those results in order to avoid misinterpretation.

50. Supervisors could consider publishing information on the scope of the exercise, the scenarios explored, the assumptions and estimates used in developing scenarios, scenario caveats, data quality challenges and modeling uncertainty and limitations.

Section 5 – Scenario analysis to inform assessment of insurers’ risk management and governance (ICP 16)

As noted in our overarching comments, the Draft Application Paper reflects an overly optimistic view of the current state of climate scenario analysis. In particular, Section 5 promotes the overutilization of climate scenario analysis to inform a firm’s risk management decisions. The Draft Application Paper reflects an overconfidence in scenario analysis use cases that does not consider important limitations and modeling challenges. These realities call for a principles-based and incremental approach to climate risk scenario analysis, where methodologies and approaches are still developing. We encourage the IAIS to include in the Draft Application Paper an exploration of current limitations and challenges associated with climate scenario analysis and to continue to consult with industry, climate scientists, and modeling experts before progressing to a final Application Paper.

In managing their exposure to climate risks, insurers consider in their modeling the *current* impacts of climate change over the strategic business planning horizon of three to five years; that is, the business-as-usual horizon. Importantly, to properly inform business decisions, the time horizons used in climate scenario analysis must align with the duration of the underlying liabilities and the characterization of the assets supporting the liabilities. While climate change is a phenomenon that materializes over a longer time horizon, some liabilities, including property catastrophe liabilities, have a much shorter duration. For longer term life insurance liabilities, insurers have deep expertise

in adjusting their assets and in managing reinvestment risk, for which climate change is one of many considerations.

In addition, climate scenario analysis is dependent upon a number of key assumptions for macroeconomic variables that are subject to considerable uncertainty over those longer-term time horizons. Given the time horizon and the degree of uncertainty, in order to be useful, climate scenarios need to reflect most likely outcomes without the undue complexity introduced by extreme scenarios and stresses on extreme tail risk assumptions.

Insurers should have the discretion to determine how best to conduct any firm-specific climate scenario analysis exercises, both in terms of the time horizon of the exercise, as well as the level of granularity. Individual insurer climate scenario exercises should focus on the climate-related financial risks that are most material to the insurer's individual risk profile. The Draft Application Paper implies that climate-related risks are material to all insurers. (See e.g., Paragraph 67.) We do not agree with this inference. The effects of climate change impact insurers and insurance lines of business differently in terms of the nature, scope, and significance of climate-related financial risks to which they are exposed. The materiality of insurers' climate risk will depend on the lines of business, activities, portfolio exposures, investment strategies, key markets and geographic footprint of a particular insurer. Further, in the assessment of the materiality of climate-related risks, it may be appropriate to reflect the impacts of group-wide diversification as a risk mitigant. A materiality assessment is a first step in designing insurer exercises and should also be a precursor to any supervisory exercises, although we acknowledge the added complexity of assessing the materiality of climate-related risks across multiple insurers within a jurisdiction.

Comments with respect to ERM framework review (Section 5.1)

The discussion of climate scenario analysis should note the limitations of and the unsuitability of the outcomes of these exercises for informing concrete risk management and business decisions today, as discussed above. The Draft Application Paper should make a clear distinction between insurance business-as-usual climate risk management, which is very well advanced (and not the topic of this Draft Application Paper) and climate scenario analysis, which has clear limitations with respect to informing risk management decisions, so as to minimize the risk of misinterpretation of the IAIS's guidance by supervisors.

Paragraph 55 states that supervisors should consider the extent to which climate risk is integrated into enterprise risk management. We would revise this sentence to provide that supervisors should consider the extent to which an insurer's *material* exposures to climate risk are integrated into its climate risk management. Moreover, a blanket statement that the outcome of scenario analysis *shall* define the resilience of the business strategy of the insurer, providing inputs into its investment and underwriting processes and pricing, as well as testing the robustness and adequacy of its solvency position, fails to take into consideration the structural limitations of this tool to inform concrete business decisions as well as the materiality of climate-related risks to the insurer. The third sentence of Paragraph 55 should be deleted; the insurer should determine whether and to what extent insights provided by climate scenario analysis can and should define its short- or long-term

strategy and management actions. In some cases, insights provided by climate scenario analysis may not be sufficiently reliable to inform business and risk management decisions and management actions.

We propose the following language for Paragraph 55:

Supervisors should consider the extent to which an insurer's material exposures to climate risk are integrated into its climate risk management.

We propose the following language for the second sentence of Paragraph 55:

The outcome of an insurer's climate scenario analysis may provide insights into the insurer's business strategy, material exposures and business risks.

The statement in Paragraph 56 that supervisors 'may wish' to consider taking a proportionate approach should be restated as supervisors 'should' take a proportionate approach.

Comments with respect to investment policies (Section 5.2)

Paragraph 58 is directed to insurers and supervisors, in conflict with the purpose of an Application Paper to provide guidance to supervisors.⁹ Subparagraph 58a. directly addresses the actions that insurers should take. Moreover, these recommendations do not consider the fact that the ability of an insurer to engage and influence an investee company can vary based on a broad range of factors. We recommend the following concluding sentence of Paragraph 58 and text for Subparagraph 58a.:

Scenario analysis can be used to better understand:

- a. The gaps in knowledge that need to be filled to understand the climate risks to which an insurer's assets are exposed.*

We propose the deletion of Subparagraph 58b., as we do not believe that supervisors or firms should include climate tipping elements or tipping points in their analyses. State of the art climate models represent all physical processes of the climate system, including feedback processes and potential tipping points. Thus, potential tipping points are already reflected to the degree possible.¹⁰

⁹ A similar consideration applies to Paragraphs 59 through 61 of the Draft Application Paper, as well as Section 5.7 with respect to Board accountability.

¹⁰ Similarly, Paragraph 29 should be reworded to remove references to tipping points.

Comments with respect to underwriting policies (Section 5.3)

We propose the deletion of Paragraphs 60 and 61, as they are directed to insurers rather than to supervisors and, thus, are inconsistent with the purpose of an Application Paper. These paragraphs also reflect a use of climate scenario analysis for risk management and decision making that is beyond the state of the art at the present time.

Comments with respect to insurers' ORSAs (Section 5.4)

The discussion of insurers' own risk and solvency assessments (ORSAs) in Section 5.4 is very prescriptive and Paragraph 67 includes a blanket statement that climate-related risks are material to the insurance industry, a statement with which we do not agree for the reasons stated above. This discussion also treats climate risk as a separate risk category, as opposed to a *driver* of financial risks, contrary to the treatment that the IAIS proposes in Paragraph 10.¹¹

With respect to incorporating the results of climate scenario analysis in an insurer's ORSA, insurers should have the discretion to decide whether to include these results in the ORSA and the flexibility to incorporate any material climate-related risks based on their analyses to the extent that the company believes that the outputs of climate scenario analysis are material, sufficiently reliable, and decision-useful. Climate-related risk drivers should not be elevated over other insurance risk drivers and all risk drivers should be considered through the lens of materiality.

Supervisors should avoid an overly prescriptive approach in their guidance to insurers in conducting the ORSA; the focus should be on what is to be achieved by the ORSA rather than how it is to be performed. The ORSA should continue to be a qualitative and quantitative assessment that is owned by the company, tailored to fit its organizational structure and risk management system, actively used by the company in its own risk management, and reflective of its individual risk profile and the materiality of various risks to its business model. As it is designed to be a springboard for confidential internal management and board discussions about risk and risk appetite and to provide a 'feedback loop' for management and the board, the results of the ORSA should not be subject to public disclosure, as this would undermine the very purpose of an ORSA.

An insurer's ORSA should primarily cover near- to medium-term material risks, consistent with the three- to five-year strategic planning horizon. The results of climate scenario analyses, particularly those based on longer time frames that involve highly uncertain climate pathways and other variables, are not useful for informing near- to medium-term risk management, including appropriate levels of capital for solvency purposes.¹²

A separate assessment of climate-related risks in the ORSA, which is currently required in some jurisdictions, may give rise to double counting of risk exposures. For example, climate-related risk exposures related to real estate may also be reflected in credit risk exposures. The IAIS should advise supervisors to avoid the double counting of risk exposures.

¹¹ More generally, references throughout the Draft Application Paper to climate risk as a separate risk category, as opposed to a driver of financial risks (e.g. Paragraph 24) should be amended in any final Application Paper.

¹² https://www.iif.com/portals/0/Files/content/Regulatory/01_21_2021_prudential_pathways.pdf

We appreciate the opportunity to comment on the Draft Application Paper on the important topic of climate scenario analysis in the insurance industry. We would be pleased to discuss our views with you and IAIS members involved in this work.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Mary Frances Monroe". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mary Frances Monroe
Director, Insurance Regulation and Policy